IP 04-1925-C T/K Conde v SLS West
Judge John D. Tinder Signed on 07/14/05

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF INDIANA
INDIANAPOLIS DIVISION

EDUARDO CONDE,	)	
KRISTA Y. CONDE,	)	
	)	
Plaintiffs,	)	
vs.	)	NO. 1:04-cv-01925-JDT-TAB
	)	
SLS WEST, LLC,	)	
CRE BROKERAGE, LLC,	)	
BROCK W. BAGLEY,	)	
RANDY W. BAGLEY,	)	
STEVEN M ESTABROOK,	)	
STEVEN C. KIRSCH,	)	
RUSSELL F. ROTH,	)	
	)	
Defendants.	)	

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF INDIANA
INDIANAPOLIS DIVISION

EDUARDO CONDE and KRISTA Y. CONDE, Plaintiffs, vs. SLS WEST, LLC f/k/a CRE BROKERAGE, LLC; BROCK W. BAGLEY; RANDY W. BAGLEY; STEVEN M. ESTABROOK; STEVEN C. KIRSCH; and RUSSELL F. ROTH, Defendants.	)	1:04-cv-1925-JDT-TAB

ENTRY ON DEFENDANTS' MOTIONS TO DISMISS (DOCKET NOS. 35, 52)

Plaintiffs Eduardo and Krista Conde bring this action against SLS West, LLC f/k/a CRE Brokerage, LLC (hereinafter "SLS"), Brock Bagley, Randy Bagley, Steven Estabrook, Steven Kirsch, and Russell Roth, alleging fraud in connection with their investment in SLS. The complaint sets forth claims under Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5, as well as a variety of state law claims. Presently before the court are the Defendants' motions to dismiss the complaint pursuant to Federal Rules of Civil Procedure 12(b)(1) and 12(b)(6) for lack of subject matter jurisdiction and failure to state a claim upon which relief may be granted.[1]

[1] The motions to dismiss now at issue have evolved over the course of the litigation. On January 13, 2005, SLS moved for dismissal pursuant to Rule 12(b)(6). The remaining Defendants joined that motion by order of the court on January 14, 2005.

I. BACKGROUND

The seeds of the present dispute were planted in August of 2003 when Randy and Brock Bagley, Estabrook, and two other non-party individuals entered into the Operating Agreement for CRE Brokerage, LLC ("CRE"), an Indiana limited liability company. Shortly thereafter, the Bagleys began to solicit Eduardo Conde's participation as an investor or partner in a business venture involving "senior life settlements."[2] Brock Bagley is the nephew of Krista Conde, Eduardo's wife. The initial members subsequently decided to change CRE's name to "SLS" in order to reflect their business strategy. Eduardo Conde declined to participate in the venture as first described, and in response the Bagleys suggested an alternative plan wherein Conde was merely to make a loan to the venture for its start-up costs. Brock Bagley also informed Conde about a new business strategy involving the use of senior life settlements to issue bonds for investors to purchase ("the bond deal"). During this time, Krista Conde's involvement in the proposed venture was also solicited. The bond deal was

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Then, on February 8, 2005, the Defendants jointly filed a motion to dismiss pursuant to Rule 12(b)(1) and a "renewed" motion to dismiss pursuant to Rule 12(b)(6). For the sake of clarity, the court will refer to the foregoing motions collectively as the Defendants' motions to dismiss.

[2] The complaint describes "senior life settlements" as follows:

> A life settlement is the sale of an existing life insurance policy for an amount greater than the policy's cash surrender value or greater than the amount the policy owner would receive if they chose to allow the policy to lapse, which in the case of a term product is that number greater than zero.

(Compl. ¶ 22.)

represented to the Condes as being one that would involve CITIGroup, the law firm of Baker & McKenzie, and a third entity called Knight Crest International Consortium Corporation ("Knight Crest").

During August and September of 2004, the Condes agreed to become involved in SLS. Two of the original members of the LLC had withdrawn by this time, and the Condes, along with Kirsch, were accepted as members. At the Condes' request, Brock Bagley was then made the manager of SLS. With the Condes involved, SLS had six members, each with a share of 16.6%.[3]

The Condes invested $500,000 in order to secure membership in SLS, and in return, SLS and its members issued a promissory note (the "Note") for that amount to the Condes on September 11, 2004. The Note bore no interest, did not exceed one year, and was to be secured by a senior life settlement policy with premiums paid in the amount of $500,000. SLS agreed to provide the Condes with proof of the terms of the security interest provision within twenty days of the Note's issuance. Failure to do so meant that the Condes could immediately declare the Note to be in default.

Along with the adoption of the Note, the members of SLS also agreed to amend the LLC operating agreement. The amendment's provisions were primarily aimed at the rights and obligations of the Condes. Specifically, the amendment provided that neither of the Condes could ever be removed or voted out as a member of SLS, but that either

[3] At this point, therefore, SLS membership consisted of the Condes, Brock and Randy Bagley, Estabrook, and Kirsch. The Condes were told that they represented the "majority in interest" due to their financial contributions.

of them could withdraw with or without cause at any time after approximately one year. The amendment also relieved the Condes from all capital-call obligations and indemnified them for claims brought against SLS that were based on events preceding their membership. Finally, the amendment required Brock Bagley and at least one other member to co-sign all checks issued by SLS.

The Condes began to perceive problems with their investment relatively soon after they became members in SLS. For one thing, SLS failed to provide proof of security for the Note. Then, in October of 2004, the bond deal collapsed. The members' efforts to secure similar deals were fruitless. Throughout this time, SLS refused to provide the Condes with the LLC's balance statements or expense reports. It is also alleged that the members, apart from the Condes, siphoned funds from SLS for personal expenses. The Condes commenced this action on November 24, 2004.

II. DISCUSSION

A. Rule 12(b)(1) Motion

The Defendants' Rule 12(b)(1) motion came late in the game. When the Defendants filed their original Rule 12(b)(6) motion they attached three exhibits that the court, by separate order, ruled would not be considered in the analysis of the underlying motion. In an apparent attempt to bring those three exhibits back into play, the Defendants filed their 12(b)(1) motion and noted that "if the complaint is formally sufficient but the contention is that there is *in fact* no subject matter jurisdiction, the movant may use affidavits and other material to support its motion." *United Phosphorus, Ltd. v. Angus Chem. Co.*, 322 F.3d 942, 946 (7th Cir. 2003) (emphasis in original).[4] While this is a correct statement of law, the Defendants fail to appreciate the consequences that result from their filing of motions to dismiss under both Rule 12(b)(1) and 12(b)(6) in a case such as the present one.

According to the Seventh Circuit, "[w]hen both the subject matter jurisdiction of the federal court and the substantive claim for relief are based on a federal statute, dismissal for lack of subject matter jurisdiction is proper only when the allegations of the complaint are frivolous." *Health Cost Controls v. Skinner*, 44 F.3d 535, 537 (7th Cir. 1995) (citing *Bell v. Hood*, 327 U.S. 678, 682 (1945)); *see also Rivanna Trawlers Unlimited v. Thompson Trawlers*, 840 F.2d 236 (4th Cir. 1988). The central issue permeating the Defendants' dismissal motions is whether particular interests are "securities," and as *Rivanna Trawlers* correctly notes, such "is both a question of subject matter jurisdiction and an element of [the plaintiffs'] asserted claims under the federal securities laws." 840 F.2d at 239 (citations omitted). Furthermore, the court finds that Plaintiffs' federal claims are not frivolous and do not appear to have been included solely for the purpose of obtaining jurisdiction over asserted state law claims. The court therefore denies the Defendants' 12(b)(1) motion to dismiss and assumes jurisdiction for the purpose of evaluating the 12(b)(6) motion.

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[4] Alternatively, the Defendants suggest that the three exhibits actually fall within the limited class of attachments that may be considered in the analysis of a 12(b)(6) motion.

B. Rule 12(b)(6) Motion

The purpose of a Rule 12(b)(6) motion to dismiss is to test the sufficiency of the complaint, not to resolve the case on the merits. *See* 5B Charles Alan Wright & Arthur R. Miller, *Federal Practice and Procedure* § 1356 (3d ed. 2004). Dismissal is appropriate only if "'it is clear that no relief could be granted under any set of facts that could be proved consistent with the allegations.'" *Ledford v. Sullivan*, 105 F.3d 354, 356 (7th Cir. 1997) (quoting *Hishon v. King & Spalding*, 467 U.S. 69, 73 (1984)). The court must accept as true all factual allegations in the complaint and draw all reasonable inferences in favor of the plaintiff. *Hentosh v. Herman M. Finch Univ. Of Health Sciences/The Chi. Med. Sch.*, 167 F.3d 1170, 1173 (7th Cir. 1999).

Federal courts adhere to a notice pleading regime, and as such a plaintiff need not plead facts so long as the defendant has at least minimal notice of the claim or claims being asserted. Fed. R. Civ. P. 8; *Scott v. City of Chicago*, 195 F.3d 950, 951 (7th Cir. 1999). That being said, "the court is not required to ignore facts alleged in the complaint that undermine the plaintiff's claim." *Slaney v. The Int'l Amateur Athletic Fed'n*, 244 F.3d 580, 597 (7th Cir. 2001). In other words, a plaintiff could conceivably plead herself out of court. *See Jefferson v. Ambroz*, 90 F.3d 1291, 1296 (7th Cir. 1996).

Moreover, because Plaintiffs allege that the Defendants engaged in fraudulent conduct, they must plead in accordance with the heightened pleading requirements established in Fed. R. Civ. P. 9(b). Rule 9(b) requires a plaintiff to plead "the who, what, when, where, and how" of the alleged fraud. *In re Healthcare Compare Corp. Securities*

Litig., 75 F.3d 276, 281 (7th Cir. 1996) (citation omitted). This heightened pleading standard is further supplemented by the Private Securities Litigation Reform Act (PSLRA), which requires plaintiff alleging securities fraud to "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1).

In this case, Count I of Plaintiffs' complaint asserts a claim for securities fraud under Section 10(b) of the Exchange Act and SEC Rule 10b-5. Section 10(b) provides that it shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails . . . [t]o use or employ, in connection with the purchase or sale of any security . . ., any manipulative or deceptive device . . . ." 15 U.S.C. § 78j(b). Similarly, Rule 10b-5 makes it "unlawful . . . [t]o employ any device, scheme, or artifice to defraud . . . in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5. With these provisions in mind, the Defendants argue that Plaintiffs' claim fails at the threshold level because neither the Note nor the Plaintiffs' interests in SLS are "securities."

i. The Note

The Exchange Act includes the phrase "any note . . ." within its definition of a "security." 15 U.S.C. § 78c(a)(10). However, Congress did not enact the federal securities laws in order "'to provide a broad federal remedy for all fraud,'" but rather intended “to regulate *investments*, in whatever form they are made and by whatever name they are called.” *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990) (citation omitted) (emphasis in original). The Supreme Court states that “the phrase ‘any note’ should not be interpreted to mean literally ‘any note,’ but must be understood against the backdrop of what Congress was attempting to accomplish in enacting the Securities Acts.” *Id*. at 62-63. To that end the Court adopted the so-called “family resemblance” test for determining whether a promissory note should be deemed a security under federal law. *Id*. at 64-65.

The family resemblance tests begins with the presumption that every note is a security. *Id*. at 67. This presumption can be rebutted if the note at issue strongly resembles one of a number of instruments that are commonly referred to as “notes” but have nonetheless been judicially determined to be non-securities.[5] *Id*. If an instrument does not bear a resemblance to any of the enumerated exceptions, the court must

[5] The Court identified the following instruments as being notes of the non-security variety:

> "‘the note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a 'character' loan to a bank customer, short-term notes secured by an assignment of accounts receivable, . . . a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized)’ . . . [and] ‘notes evidencing loans by commercial banks for current operations.’"

Reves, 494 U.S. at 65 (citations omitted).

determine if it is of a type that should be added to the list by examining four factors identified in *Reves* as being indicative of non-security notes. *Id*. These factors consist of: (1) "the motivations that would prompt a reasonable seller and buyer to enter into [the transaction]"; (2) "the 'plan of distribution' of the instrument"; (3) "the reasonable expectations of the investing public"; and (4) "whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary." *Id*. at 66-67.

Under the first *Reves* factor, a note resembles a security "[i]f the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate." *Id*. at 66. By contrast, a note that "is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose" will "less sensibly [be] described as a 'security.'" *Id*. The court must look objectively at "the motivations that would prompt a reasonable seller and buyer to enter into [the transaction]." *Id*. If the surrounding motivations appear to be geared toward investment, then the instrument at issue is more likely a security. *Pollack v. Laidlaw Holdings, Inc*., 27 F.3d 808, 812 (2d Cir. 1994).

The Defendants argue that this first factor works in their favor because the Note had a zero interest rate, which they interpret as meaning Plaintiffs could not have been motivated by an expectation of profit from the Note. While acknowledging that a rate of return in the form of interest is typically the most obvious form of "profit" related to notes, Plaintiffs contend that the Defendants' view is unduly narrow by citing the *Reves* Court's explanation "that by 'profit' in the context of notes, we mean 'a valuable return on an investment,' which undoubtedly *includes* interest." 494 U.S. at 68 n.4 (citation omitted) (emphasis added). Plaintiffs argue that a reasonable approach to this language should cause one to read not a requirement that there be interest, but that the presence of interest can be probative of profit.

While Plaintiffs may be correct that the Defendants' view of profit as relating solely to interest assumes too much, this does not help their cause. The only fair reading of the complaint indicates that the Note was given in exchange for the Plaintiffs' capital contributions as a way of providing security for their investment in SLS. As will be explored in the next section of this entry, any potential profits were to come from Plaintiffs' LLC interests and not the Note. Thus, while their contributions were undoubtedly to be used to fund the general business operations of the venture, the Plaintiffs were not interested primarily in any profit the Note was expected to generate. This conclusion is bolstered by the fact that the LLC operating agreement required Plaintiffs to remain as members of SLS for a minimum amount of time that corresponded to the life of the Note – one year. The Note was used simply as a safety net so that the Plaintiffs would not suffer a complete loss in the event SLS collapsed in its first year of operation. If everything had worked according to plan, after one year the Plaintiffs would have received payment on the Note and remained as members of SLS with the hope that the Defendants' business strategy would fill their coffers with profits in proportion to their LLC interests. If Plaintiffs were hoping to obtain profits on top of those received from the LLC interests, then the Defendants are undoubtedly correct that interest on the Note would have been the way to do so. Thus, the first *Reves* factor tips in favor of the Defendants.

The second factor requires the court to examine the plan of distribution of the Note in order to determine whether it "is an instrument in which there is common trading for speculation or investment." *Reves*, 494 U.S. at 66. In this case, the Note was part of a single, unique transaction wherein it was offered solely to Plaintiffs Mr. and Mrs. Conde. Two customers who form a single married couple surely do not constitute "a broad segment of the public." *Stoiber v. SEC*, 161 F.3d 745, 751 (D.C. Cir. 1998). The instant situation therefore stands in stark contrast to *Reves*, which involved notes that were offered to tens of thousands of individuals. *Reves*, 494 U.S. at 68; *see Bass v. Janney Montgomery Scott, Inc*., 210 F.3d 577, 586 (6th Cir. 2000) (finding that the second *Reves* factor "tilts against the notes being securities, since the transaction was unique, negotiated with a single buyer and negotiated term by term, rather than being offered in a wholesale or potentially wholesale fashion). Plaintiffs' argument that they are individuals as opposed sophisticated financial institutions – and thus in need of protection – is not instructive. The fact that Mr. and Mrs. Conde made such a considerable investment tends to indicate that they are persons who had the financial capability to acquire assistance and information related to the underlying transaction if they deemed such to be necessary. *See Banco Espanol de Credito v. Sec. Pac. Nat'l Bank*, 973 F.2d 51, 55 (2d Cir. 1992). In short, the plan of distribution in this case weighs against finding the Note to be a security.

The third *Reves* factor focuses on whether a reasonable member of the investing public would think of the subject note as an investment. 494 U.S. at 66. At issue "is what a 'reasonable investor' would think, not what the 'specific individuals in question' might have thought." *SEC v. Wallenbrock*, 313 F.3d 532, 539 (9^{th} Cir. 2002) (citation omitted). *Reves* notes further that instruments may be considered "securities" on the basis of public expectations "even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not 'securities' as used in that transaction." 494 U.S. at 66. Here, and for many of the same reasons described in the court's discussion of the first *Reves* factor, no reasonable investor would have perceived the Note to be a security. The Note was for an extremely short period (one year) and by its own terms offered no direct chance for a profit. Any profit from the Plaintiffs' investment was to come from their interests in SLS. Furthermore, there is nothing on the face of the complaint that indicates the Defendants ever called the Note an "investment." Thus, the third factor instructs against finding the Note to be a security.

The final *Reves* factor, risk reduction, requires the court to assess whether certain circumstances – such as the existence of collateral, insurance, or alternative regulatory schemes – render the protection afforded by the federal securities laws unnecessary. 494 U.S. at 67; *Stoiber*, 161 F.3d at 751. In the present case, the Note was ostensibly collateralized. As the complaint indicates, however, "the so-called collateralization appears to be a fiction." *Wallenbrock*, 313 F.3d at 539. By the time Plaintiffs initiated these proceedings they had little to no basis for believing that their interests were protected by any collateral because the proof of collateral was never revealed to them within the time frame set forth by the Note's terms. And while the Note was for a short term, and thus somewhat less risky, it was also highly illiquid due to the overall uniqueness and familial nature of the transaction. *See id.* at 540. Finally, the Defendants fail to point out any alternative regulatory scheme applicable to the Note.[6] These circumstances all indicate that there are no risk-reducing factors at issue that will render the protection of the federal securities laws unnecessary in this case.

After considering each of the *Reves* factors and the economic realities of the underlying transaction, the court concludes that the Note cannot be deemed a "security." The Plaintiffs did not hope to profit directly from the Note, the Note's plan of distribution was extremely narrow, and no reasonable member of the investing public would have considered the Note to be a security. Only the final *Reves* factor related to risk reduction points in favor of Plaintiffs. However, that factor alone is not dispositive and does not outweigh the court's other findings.

But this conclusion does not end the inquiry. The court must now determine whether Plaintiffs have stated a claim regarding the security status of their interests in SLS, the subject LLC.

ii. LLC Interests

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[6] The Defendants also argue that the Plaintiffs were able to reduce any risk associated with the Note due to their level of control over the enterprise. However, this issue is best left for the court's discussion on the security status of the Plaintiffs' LLC interests in section II.B.ii *infra*.

As limited liability companies (LLCs) emerge as viable and often preferable alternatives[7] to the traditional corporate form, the security status of their members' interests is an issue that will likely remain at the forefront of development in this area. *See generally* Larry E. Ribstein, *Form and Substance in the Definition of a "Security": The Case of Limited Liability Companies*, 51 Wash. & Lee L. Rev. 807 (1994). In this case, the question of whether Plaintiffs interests in SLS constitute "securities" within the meaning of the Exchange Act requires the court to journey into a relatively new and evolving legal landscape.

But first things first. As was true for the Note discussed above, in order for Plaintiffs to state a claim under Section 10(b) of the Exchange Act and Rule 10b-5 with respect to their LLC interests they must first demonstrate that such interests fall within the statutory definition of a "security." The Exchange Act provides that "[t]he term 'security' means any note, stock . . . investment contract . . . or in general, any instrument commonly known as a 'security' . . . ." 15 U.S.C. § 78c(a)(10). Both sides agree that the critical inquiry in this case is whether the subject LLC interests should be deemed "investment contracts" so that the federal securities laws will apply.

In the seminal case of *SEC v. W.J. Howey, Co.*, the Supreme Court defined an investment contract as "a contract, transaction or scheme whereby a person invests his

[7] LLCs are non-corporate business associations that combine many of the characteristics found in general partnerships, limited partnerships, and corporations in order to offer their members limited liability, considerable organizational flexibility, and certain tax benefits. Under Indiana law, LLCs are governed by the "Indiana Business Flexibility Act." Ind. Code § 23-18-1-1 *et seq*.

money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." 328 U.S. 293, 298-99 (1946). This definition has been recast in a familiar three-step test that requires: (1) "an investment of money"; (2) "in a common enterprise"; (3) "with profits to come solely from the efforts of others." *Id*. at 301; *Coward v. Colgate-Palmolive Co.*, 686 F.2d 1230, 1236 (7th Cir. 1982). The analysis essentially elevates the substance of the underlying transaction over its form, embodying "a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." *Howey*, 328 U.S. at 299. Here, the parties dispute only two aspects of the *Howey* test: whether the Plaintiffs made an investment of money and expected profits from the efforts of others.

An "investment of money" requires an investor to have relinquished "a specific consideration in return for a separable financial interest with the characteristics of a security." *Int'l Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 559 (1979). The term has also been described as a commitment of "assets to [an] enterprise in such a manner as to subject [the investor] to financial loss." *SEC v. Rubera*, 350 F.3d 1084, 1090 (9th Cir. 2003) (citations omitted). In this case, Plaintiffs have sufficiently alleged the requisite investment of money under either phrasing . The addendum attached to the SLS operating agreement clearly contemplates that Plaintiffs' payment in an amount equal to the Note represented their capital contribution and purchase price for the LLC interests. By buying-in and becoming members, Plaintiffs then expected to receive a profit derived from the unique business strategy employed by the Defendants – a strategy that depended on specialized knowledge outside of the Plaintiffs' expertise, thereby posing a risk of loss. In short, Plaintiffs invested money "in anticipation of investment gains" so that the first prong of the *Howey* test has been satisfied. *SEC v. SG Ltd.*, 265 F.3d 42, 49 (1st Cir. 2001).

Turning next to the "efforts of others" aspect of the *Howey* test, the court is mindful that this element typically represents the determinative factor in any security analysis of LLC interests. *See* 2 Larry E. Ribstein & Robert R. Keatinge, *Ribstein and Keatinge on Limited Liability Companies* § 14:2 (2004). It is useful to begin this discussion by looking at developments in partnership law. In the context of general partnerships, default rules providing for equal management rights and personal liability among the partners have generally led courts to find that the partners do not expect profits from the efforts of others. *See Rivanna Trawlers,* 840 F.2d at 240-41. The one caveat to that rule depends on the ability of the partners to exercise their powers within the general partnership. If a general partner has so little power over management that he has effectively been rendered a passive investor, then his partnership interest may be an investment contract. *Williamson v. Tucker*, 645 F.2d 404, 423-24 (5th Cir. 1981).

At first blush, an analogy between general partnerships and LLCs may appear appropriate because like the law of partnerships, the Indiana LLC statute establishes a default rule of management by members. Ind. Code § 23-18-4-1(a). However, the same statute allows parties to opt out of the default rule in favor of management by a manager or a group of managers. *Id*. Members of a manager-managed LLC are more likely to be passive investors in need of the protections afforded by the federal securities laws. *See Robinson v. Glynn*, 349 F.3d 166, 174 (4th Cir. 2003). By the same token, members of member-managed LLCs who are able to actively participate in the management affairs of the entity are less likely to need such protections. *Id*. But even these characteristics may differ based on the economic realities and facts of each case, making it difficult to establish bright line rules in this area. *Id*. Thus, the structure of an LLC's operating agreement becomes crucial to the security status analysis, as does the ability of each member to exercise his or her rights.

In the present case, the SLS operating agreement opted for day-to-day management by a group of five managers elected by and removable by the members. The agreement further provided that a majority in interest of the members could limit the duties of the managers and/or remove the managers with or without cause. Defendants seize on such rights and note that Plaintiffs claim they believed their LLC interests would in fact represent the majority in interest.[8] If the Defendants' characterization is correct, the Plaintiffs' ability to veto any management decision and remove managers at will would weaken their claim of passivity. However, Plaintiffs have plead facts that paint quite a different picture of their "rights."

The complaint indicates that Plaintiffs did not have the ability to exercise any power over the management of SLS in order to protect their investment even if they had wanted to. Despite having the right to inspect the books and records of SLS, Plaintiffs attempts to exercise that right went ignored by the Defendants. Defendant Brock

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[8] While Plaintiffs may have *thought* they represented the majority in interest, this was never memorialized in the operating agreement nor its addendum.

Bagley had the ability to write company checks so long as he had one other member's signature, and used his power to write several checks to other members in order to pay "expenses." Yet, when the Plaintiffs made inquiries into those payments they received no reply nor explanation.

Finally, the Defendants' business strategy relied primarily on specialized knowledge and expertise related to senior life settlements and bonds. The details of each potential "deal" were researched solely by the Defendants – who described themselves as "experts" – while Plaintiffs were kept on the sidelines as mere observers. Such circumstances make it more likely that Plaintiffs were left dependent on the other members for their investment's profitability. *See Williamson*, 645 F.2d at 424 (general partnership context).

A very different view may emerge at the summary judgment stage and upon further factual development, but until then, Plaintiffs have sufficiently alleged that they did not possess a level of control over the enterprise that would render the protection of the federal securities laws unnecessary.[9] Plaintiffs appear simply to be passive investors dependent upon the efforts of others.

III. CONCLUSION

[9] Though the court has refrained from dismissing this action for failure to state a claim regarding the subject LLC interests, Plaintiffs are encouraged to consider whether they wish to continue pursuing their fraud claims under *federal* law. The underlying transaction involves a closely held Indiana limited liability company, and there is no indication that Indiana's state courts would have difficulty addressing Plaintiffs' contentions. *See* Ribstein & Keatinge, *supra*.

Based on the foregoing, Plaintiffs' complaint will not be dismissed for failure to state a claim. While the Defendants are correct that the Note cannot be characterized as a "security" under federal law, this does not end the analysis. The Plaintiffs have gone a step further and sufficiently shown that their interests in SLS are securities.

The Defendants' motions to dismiss are hereby **DENIED**.

ALL OF WHICH IS ENTERED this 14th day of July 2005.

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John Daniel Tinder, Judge
United States District Court

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